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NOT TO BE PUBLISHED IN OFFICIAL REPORTS

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

FOURTH APPELLATE DISTRICT

DIVISION THREE

2151 MICHELSON, L.P.,	
Plaintiff and Respondent,	G039654
v.	(Super. Ct. No. 04CC05362)
CORPORATION OF THE PRESIDING BISHOP OF THE CHURCH OF JESUS CHRIST OF LATTER-DAY SAINTS,	O P I N I O N
Defendant and Appellant.	

Appeal from a judgment of the Superior Court of Orange County, Sheila B. Fell, Judge. Affirmed.

Kirton & McConkie, Eric C. Olson, Alexander Dushku, Christopher S. Hill; Latham & Watkins, Jon D. Anderson for Defendant and Appellant.

Malat & Malat, Gerald A. Malat; Daniel C. Leib, A Law Corporation, Daniel C. Leib for Plaintiff and Respondent.

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To observe that the value of real estate in Orange County increased from 1977 to 2002 would be an understatement. Nevertheless, the trial court declined to provide an upward adjustment in rent pursuant to a lease executed in 1977 and set to adjust in 2002 to a "sum which the Lessor could derive from said property if it were made available on the open market for new leasing purposes." We are asked to review this seemingly paradoxical result.

Defendant CPB[1] is the lessor and plaintiff 2151 Michelson, L.P. (Michelson) is the lessee of real estate at 2151 Michelson Avenue in Irvine, California (the Property). The 55 year ground lease governing the parties' relationship provides lessee with the right to construct and operate an office building at the previously unimproved Property for the term of the lease, whereupon the rights to use and possession of the Property (including all improvements made by the lessee) revert to lessor. In exchange, the lessee pays $88,165 in annual rent for the first 25 years of the lease (until June 1, 2002), plus a minimum annual rent of $88,165 for the remainder of the lease term. The rent is subject to upward adjustment in the 25th and 40th years of the lease, but such adjustment must be calculated under the hypothetical assumption that the lessee's improvements do not exist; in other words, the adjusted rent is what lessor could obtain (in 2002 and 2017) on the "open market" for a 55 year ground lease at the Property without any of the improvements actually constructed.

Michelson filed a declaratory relief action, claiming no upward adjustment in rent was justified as of June 1, 2002. CPB requested the court to find annual rent for 2002 to 2017 in the amount of $513,000. The court found in favor of Michelson after weighing the percipient and expert testimony introduced by the parties. The court found the lease did not call for the straightforward application of the sales comparison approach

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[1] We will follow the parties' convention of using "CPB" as a shortened designation for defendant Corporation of the Presiding Bishop of the Church of Jesus Christ of the Latter-Day Saints.

advanced by CPB (appraising the value of the land by using contemporary sales of comparable properties, then multiplying the appraised land value by a market rate of return for commercial leases to obtain the adjusted rent number). Instead, the court credited evidence submitted by Michelson's experts tending to establish the Orange County commercial real estate market in 2002 would not support a ground lease transaction as contemplated by the lease — thus, the Property could not get a higher rent on the "open market" with the same terms of the lease at issue. Because we agree with the court's interpretation of the lease, and because there is substantial evidence supporting the court's application of the rent adjustment provision to the facts in this case, we affirm.

FACTS

Background

In 1977, real estate giant The Irvine Company owned the Property, which was unimproved at the time. On June 1, 1977, the Irvine Company entered into a 55 year ground lease of the Property with Bauer Development Company, a firm headed by Warren Bauer. CPB is the successor in interest to The Irvine Company; CPB purchased the Property in 1992. Michelson is the successor in interest to the ground lease tenancy; it acquired its rights in 1993.

The June 1, 1977 ground lease includes the following provisions, quoted in relevant part:

- Paragraph 2: "<u>Term</u>: The term shall be fifty-five (55) years commencing on the 1st day of June, 1977 and ending on the 31st day of May, 2032."
- Paragraph 3: "<u>Rental</u>: Lessee agrees to pay as annual rental for the use and occupancy of the leased premises during the term of this Lease the following sums: [¶] (a) <u>Basic Rental</u>: The basic annual rental shall be

[$88,165]." [¶] (b) Adjusted Basic Rental: Upon the expiration of the twenty-fifth (25th) year and the fortieth (40th) year of the term of this Lease, the basic rental shall be adjusted to that sum which the Lessor could derive from said property if it were made available on the open market for new leasing purposes for the use set out in Paragraph 4 below (exclusive of the value of Lessee's improvements thereon); provided, however, in no event shall the basic rental as so adjusted be less than the basic rental payable for the preceding period. [¶] After such adjustment of the basic rental, if any, Lessee shall pay to Lessor such adjusted basic rental . . . ."

- Paragraph 4: "Use: Lessee shall use the leased premises for the construction and operation of an office building or buildings, and uses related thereto, for business and professional offices primarily serving commerce and industry; together with that number of parking spaces sufficient to provide parking spaces as required by the City of Irvine Code, or variances thereto, for said office building(s); provided, however, that Lessee shall not sublet said office building(s) for the operation of a savings and loan association or a public restaurant."

Warren Bauer testified that the Irvine Company presented him with the lease terms as reflected in the executed lease; he did not negotiate the initial rent of $88,165 or the procedures for adjusting the rent in the 25th and 40th years of the lease. Instead, Bauer evaluated the likely future annual income from the improvements he could build at the Property under the lease, as compared with the likely annual expenses, including the ground lease rent and payments on the loan required to construct the office building. Bauer decided to sign the ground lease based on his analysis of the project's economic feasibility. Bauer Development Company completed construction of an office building at the Property within a year following execution of the lease, and operated the building until high vacancy rates led to a foreclosure by its lender in the early 1990's.

Procedural History

Needless to say, the parties could not agree on an appropriate rent in 2002, and Michelson filed this action seeking declaratory relief. Trial commenced in 2005. Although the majority of the evidence submitted by the parties was comprised of expert testimony and reports related to the appraisal and economic valuation of the Property and the ground lease, significant testimony and documentary evidence concerned the oral statements and written communications of the parties' agents at or around the time the dispute arose.

The first court to evaluate this evidence ruled in favor of Michelson, finding the lease called for an adjustment of rent to occur six months prior to June 1, 2002, and concluding CPB waived its right to adjust the rent by waiting until after June 1, 2002 to initiate the process of adjusting the rent. In *2151 Michelson v. Corporation of the Presiding Bishop of the Church of Jesus Christ of Latter Day Saints* (May 18, 2006, G035864) [nonpub. opn.]), we reversed and remanded for further proceedings. In our view, "[t]here is no language in the contract either expressly or inferentially creating the condition of forfeiture imposed by the [first] court [and] there is no *evidence* demonstrating waiver [in the record]." (*Id*. at pp. 6-7.)

Upon remand, the parties stipulated to a new bench trial upon the written record from the first trial, with all objections raised on the record of the first trial preserved. Thus, the same testimony and exhibits are part of the record here. However, we need not set out in detail evidence of the parties' strategic positioning and missteps from 2001 to 2004,[2] as such evidence ultimately has no impact on the meaning of the

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[2] For instance: in 2001, CPB's agent created an abstract of the ground lease in which it included a placeholder "estimate" of $140,000 rent for the period of 2002 to

lease or on the actual rent that could be derived from the Property on the "open market" in 2002.

Valuation of the Annual Rent

The parties agree the lease requires the rent adjustment, "if any," to be decided on the basis of a valuation of a hypothetical transaction belying the actual circumstances at the Property in June 2002. First, it must be imagined the improvements to the Property do not exist, because the rent for the Property must be determined "exclusive of the value of Lessee's improvements thereon." Second, the relevant question is the market valuation of a new 55 year ground lease in 2002, with the same terms and conditions as those contained in the original ground lease (other than an adjustment of dates). This interpretation follows from the lease's directive to adjust the rent based on making the Property available "on the open market for new leasing purposes . . . ." Neither party contends the lease demands a valuation of a 30 year ground lease (the remainder of the actual term), which would presumably reduce the value of the leasehold. The parties stipulate that the only permitted use of the Property in 2002 was for an office building similar in size to the building actually in existence.

The parties, then, agree on some basic parameters of the valuation problem presented by the lease, and further agree expert testimony is required to establish an answer to the problem. The parties vigorously contest two fundamental issues: (1) what

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2016; CPB claimed in February 2003 that the adjusted rent should be based on a discredited appraisal not offered at trial, which set forth a recommended annual rent of $712,000; CPB's expert appraiser mistakenly completed his first report with an appraisal date of June 2003 rather than June 2002; and Michelson may have been amenable to a rent increase in the range of $140,000 had negotiations led to such an offer from CPB. As explained above, we have already rejected a finding of waiver or forfeiture on this record. Moreover, other issues to which this evidence might pertain that were raised by the pleadings, such as estoppel, are not before us on appeal.

is the appropriate valuation methodology or methodologies; and (2) assuming a particular methodology can be utilized, what assumptions are appropriate in applying that methodology to the specific ground lease at issue. The parties both submitted expert testimony and reports to support their respective contentions as to the questions posed above, as well as their answers to the ultimate issue of the appropriate rent for 2002 through 2016. John Adams, a member of the appraisal institute familiar with Orange County real estate, testified for CPB. Michelson relied on two experts: James Netzer, a member of the appraisal institute familiar with Orange County real estate; and John Harty, a principal at Trammell Crow Company (a nationally regarded real estate development firm) with experience planning and overseeing commercial real estate developments.

CPB's Expert Valuation Analysis

CPB's expert, John Adams, developed a "two-step approach" to establishing the appropriate rent for the Property. He testified his approach was "the common methodology used to establish ground rent" in the marketplace.

Step one relies primarily on a "sales comparison approach" to establish the fair market value of the "vacant" Property. This appraisal method utilizes sale prices of fee simple interests in real properties selected by Adams as "comparable" to the Property (considering factors such as proximity, date of sale, and zoning) to establish an appraisal of the market value (at a particular moment — June 1, 2002) of the Property. Adams concludes the (hypothetical) unimproved Property had a price per square foot of $26 as of June 1, 2002, and the market value was $5,731,000 using price per square foot. Adams further concludes (using the same comparable properties) the price per floor area ratio (FAR) was between $60 and $65, resulting in a fair market value range of $5,630,000 to $6,100,000.

Adams also completed a "land residual" analysis "as a check" on his market value findings; the land residual approach employed by Adams has a similar conceptual basis to the mode of analysis employed by Michelson's experts. According to Adams, "[t]he land residual analysis is a method of estimating land value . . . when you can determine what the income attributable to the improvements would be and you can determine the costs of the improvements . . . ." Based on the assumptions utilized by Adams, his land residual analysis establishes a land value of $4,998,000.[3] By placing more emphasis on the sales comparison approach, Adams concludes the first step by reconciling his appraisal of fair market land value at $5,700,000. Adams criticized overreliance on land residual analysis as "more of a hypothetical. It takes a lot more assumptions where you are making assumptions of cost, rent, expenses, capitalization rates, versus going directly to the market where you needed two components, land value and rental rates of return, which were easily discernible in the market."

Step two of Adams's analysis consists of identifying different properties with ground leases (not the same comparable properties used for his appraisal of the fair market value) to determine what the open market "rate of return" was in 2002 for ground lease landlords. First, his report identifies five ground leases entered into from March 1998 to August 2001,[4] with rates of return to the lessor ranging from 9.0 percent to 10.0 percent. The lessees to these five leases included two Home Depot stores, one retail center, one school district maintenance yard, and one office (this particular lease was purportedly executed in August 1999). Next, Adams's report references his interviews with various large landholders, in which the landholders indicated they received from 9.0

3 The mathematical details of Adams's land residual analysis are set forth below, alongside the Netzer analysis.

4 The ground leases were not entered into evidence. Ground leases entered into in 2002 "weren't available" according to Adams. Adams attributed the dearth of ground lease transactions to the lack of vacant properties available for new commercial development in Orange County in the early 2000's.

percent to 10.0 percent rates of return on ground leases for unspecified property uses. Finally, Adams's report identifies the rents agreed to by the parties to three ground leases whose rents were set to adjust in 2002; the rates of return ranged from 8.0 percent to 10.0 percent. Adams concludes a 9.0 percent rate of return was a "fair market rent" for a ground lease of commercial property.

Based on Adams's appraisal of the fair market value of the unimproved Property ($5,700,000) and his determination that a ground lease rent should provide an annual return of 9 percent, Adams concludes the rent that could be derived from the Property as of June 1, 2002 was $513,000 per year ($513,000 = $5,700,000 x .09).

Michelson's Expert Valuation Analysis

Michelson's experts set out not to determine the fair market value of the Property, but instead to answer in June 2002's market the same question Warren Bauer answered in 1977: does this transaction make sense for a potential lessee interested in developing an office building? By Michelson's logic, the fair market value of the land and the fair market return to the lessor as determined by Adams are simply irrelevant to determining the rent as dictated by the lease because there was no rational developer willing to actually pay the rent contemplated by Adams's appraisal as of June 1, 2002, given the constraints placed on the Property by the lease and the City of Irvine's zoning regulations.

Both appraiser James Netzer and developer John Harty claim a ground lease development at the Property was "impossible to do" in 2002. By crunching the numbers, Netzer and Harty each conclude an investor or developer could not generate sufficient income at the Property to both pay ground lease to CPB and "pay" itself with an acceptable rate of return. Harty stated "a ground lease development on that site, at that time, was . . . impossible to do." "There was no market." "There was no way to finance it. There was no rational developer who would move forward on an office building on a leasehold interest during that time in June of 2002." The lack of ground lease office building deals in 2002 supports this conclusion, according to Netzer and Harty. Relatedly, Michelson's experts criticize Adams for lacking the ability to identify true comparable transactions: Adams does not have a single new office building ground lease transaction in 2002 in his analysis. Netzer testified: "[T]he entire [Adams] analysis assumes that there is demand for a leasehold office building, and there is no analysis to show that someone would actually build a leasehold office building in 2002."

The Parties' Competing "Residual" Analyses

The experts' "residual" calculations are based on a mathematical formula utilized in the income capitalization approach to property appraisal, which is commonly used to evaluate commercial property investments: present (market) value of the property = net operating income (NOI)[5] or "net return" / capitalization rate (cap rate).[6] (See Cal. Code Regs., tit. 18, § 8; *Dominguez Energy v. County of Los Angeles* (1997) 56 Cal.App.4th 839, 845-846.) Stated in this manner (present value (or "cost") = NOI / cap rate), one may conduct a market value estimate of an income generating property. To use a simplified example, if a property generates $100,000 in annual NOI, and if the cap rate is 10 percent, the value of the property would be $1 million under the income capitalization approach.[7] The following is a side-by-side comparison of the assumptions

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5 NOI is "[i]ncome derived from operating a business, after subtracting operating costs." (Black's Law Dict. (7th ed. 1999) p. 767, col. 2.)

6 A capitalization rate is "[t]he interest rate used in calculating the present value of future periodic payments." (Black's Law Dict., *supra,* p. 202, col. 1.) Investors will accept different cap rates for different properties at different points in time, depending upon investment alternatives and differing levels of risks inherent in the use, location, and other characteristics of the property.

7 Through simple algebraic manipulation, the formula can be restated: cap rate = NOI / cost, or NOI = cap rate x cost.

and calculations utilized in the Adams and Netzer “residual” analyses; the order of each analysis has been modified to allow comparison.

	Adams	**Netzer**
Total Construction **Cost**	**$13,497,000** (includes 15% one-time developer’s profit)	**$11,260,800**
Annual Gross Income	$2,421,072	$2,252,160
Vacancy and Collection Loss at 5%	$121,054	$112,608
Operating Expenses (Ignoring Ground Rent)	$774,180	$674,450
Net Operating Income (Ignoring Ground Rent)	**$1,525,838**	**$1,465,102**
Capitalization Rate	**8.25%**	**15.0%**
Residual Land Value: Land Value (X) = (NOI / cap rate) – Total Construction Cost	**$4,998,006** X = ($1,525,838 / 8.25%) - $13,497,000	Netzer Did Not Calculate; [-$1,493,454] X = ($1,465,102 / 15%) - $11,260,800)
NOI Needed to Support Construction: Cost x cap rate = NOI	Adams Did Not Calculate [$1,113,502] ($13,497,000 x 8.25%)	**$1,689,120** ($11,260,800 x 15%)
Potential Ground Rent Payment: (Estimated Actual NOI – NOI Needed to Support Construction)	Adams Did Not Calculate [$412,336] ($1,525,838 - $1,113,502)	**-$224,018** ($1,465,102 - $1,689,120)

As explained above, Adams utilized his residual land analysis as a "check" on his sales comparison appraisal of the value of the land. Thus, he derived the residual land value using the estimated cost of construction, the estimated NOI (ignoring rent payments), and the estimated cap rate. Adams's land residual analysis assumes fee simple ownership and operation of the Property. If CPB constructed an office building and leased out the office space, it would not be required to pay ground rent to itself.

Netzer, on the other hand, sought to derive directly the maximum amount of rent that could be paid by a party under a ground lease at the Property. Thus, he did not estimate the value of the land, but instead demonstrated (under his assumptions) the lack of sufficient estimated gross income from the Property to both pay ground lease rent and attain an acceptable return on investment as measured by the cap rate. The gross income estimates by the parties represent the rent the Property could generate with improvements. A ground lease divides the potential income from the Property. Under a ground lease, the gross income generated by the office building must pay for the ground rent (for use of the land); lessee's return on investment can be taken from NOI only after the lessee's rent is paid. Adams's analysis ignores the ground rent as an expense to be deducted from annual gross income to arrive at NOI (because it assumes fee simple ownership).

A cursory review of the data assumptions by Adams and Netzer reveals a significant difference in the cap rate selected; none of the cost and income assumptions of the two appraisal experts differ significantly.[8] Adams's report establishes 8.25 percent as his assumed cap rate on the following basis: "Sales data for office buildings in the general airport area during 2001-2003 indicate capitalization rates ranging from 7.2% to

[8] Adams added a one time 15 percent profit for the construction of the office building. Adams reasoned that the developer and the builder would represent two different entities: the builder could be paid a one-time 15 percent premium, and the developer would be satisfied with an annual return of 8.25 percent. This represents much of the difference between the two experts' estimates of cost of construction.

8.9% with a majority in the 8.0% to 8.7% range." Adams testified he focused on the sale of new two-story office buildings in determining the cap rate. Adams was not trying to establish a cap rate for a ground lessee investor or developer; he was measuring residual land value based on fee simple ownership.

Netzer's report offered the following explanation for his 15 percent cap rate: "[T]he 15-percent internal rate of return reflects a non-leveraged return for a low risk, Fee Simple development project; however, the [developers, property owners, and commercial real estate brokers I] interviewed reported they would anticipate return requirements from 25- to 35-percent for the construction of leasehold office improvements due to the risk associated with office development and the fact that the improvements revert to the leasehold owner at the end of the lease term and there is no reversionary value." Thus, Netzer claims his 15 percent cap rate is a lowball placeholder used to illustrate his analysis. Adams disagreed with Netzer's 15 percent cap rate, claiming Netzer confused a return on investment for the development (a one time profit, which Adams estimated as 15 percent of the construction costs) with a cap rate, which is the rate of return on the capital investment in perpetuity (or, at least, for the useful life of the capital investment or, alternatively, the term of the lease).

Harty also prepared a land residual analysis based on "what someone could pay or what we could pay or any prudent developer could pay in ground lease to do this deal" if "push came to shove" and the deal simply had to be completed.

Gross Income	$1,520,208
Vacancy and Collection Loss	($76,010.40)
Structural Reserves	($112,608)
Ground Rent	($103,224)
NOI	$1,228,366

Cap Rate	9.7%
Value	$12,663,562
Cost of Development	($11,513,533)
Land Value (Residual)[9]	$1,150,029

Applying Netzer's methodology to Harty's cost, income, and cap rate assumptions add some insight to a review of the evidence.

<u>NOI Needed to Support Construction</u>: (Cost x cap rate = NOI)	$1,116,813 ($11,513,533 x 9.7%)
<u>Potential Ground Rent Payment</u>: (Estimated Actual NOI not including ground rent – NOI Needed to Support Construction)	$215,057 ($1,331,590 - $1,116,533)

Harty clarified his analysis applied only if "someone had a gun to [his] head, [and] even then I probably wouldn't do it. [¶] You see, the issue really is not how much could you pay. The issue is, can you pay anything at all? Is there a market for ground lease development? At that time [June of 2002], there was no market for it." "[I]f there was a market for ground lease properties, this is what someone could pay." Thus, according to Harty, it is mathematically feasible (if not actually feasible because of financing issues) for a developer to meet its financial "cash on cash" goals and internal rate of return goals by pursuing a ground lease at the Property with $103,224 in ground

9 Harty's analysis actually set the land residual value at $706,805.19, after including $443,224.70 in "selling costs." We have ignored this additional deduction for purposes of comparing his data to that of Adams and Netzer.

rent, assuming a 9.7 percent cap rate.[10] Harty testified the 9.7 percent cap rate was "too low for ground lease deals, but it's just what was used."

Judgment for Michelson

The second court to evaluate the evidence entered judgment in favor of Michelson. This time, the judgment squarely addressed the substantive issue of whether a rent adjustment was appropriate. In the court's tentative decision, it explained the ground lease "did not specify an appraisal or comparison formula for determining a value of the leasehold or the ground, and the 'if any' modifier with relation to adjusted rent clearly opens the equation to a negative rent [adjustment, but for] the $88,165 per year rent [floor] as established [elsewhere in the lease]." The court concluded CPB failed to establish "a basis for an increase in the annual rent for the subject property." CPB timely filed a notice of appeal of the judgment.

DISCUSSION

On appeal, CPB submits the judgment must be reversed based on two errors purportedly committed by the court. First, CPB claims the court wrongly interpreted the lease to require the application of a particular methodology, the "land residual analysis," and to exclude consideration of the sales comparison approach advocated by Adams. Second, CPB claims the court abdicated its role as fact finder by not finding any rent increase. CPB characterizes a portion of the court's tentative decision[11] as an indication

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[10] Harty's analysis assumes the developer will finance the deal, and will therefore be primarily interested in financial metrics measuring return on cash actually invested. This contrasts with Netzer's approach, which assumed a cash investment by the developer in paying for construction costs, and Adams's approach, which ignored financing issues.

[11] The relevant portion of the court's tentative decision states: "In order to accept the assertions of Defendant in this matter, however, the Court must, in essence

that the court incorrectly interpreted the lease and opted not to evaluate whether any rent increase was appropriate.

The court's tentative decision states: "This tentative decision shall serve as the Court's statement of decision unless within 10 days either party specifies controverted issues or makes proposals not covered in this tentative decision." This language tracks, in part, Code of Civil Procedure section 632: "The request for a statement of decision shall specify those controverted issues as to which the party is requesting a statement of decision." Moreover, Code of Civil Procedure section 634 provides: "When a statement of decision does not resolve a controverted issue, or if the statement is ambiguous and the record shows that the omission or ambiguity was brought to the attention of the trial court either prior to entry of judgment or in conjunction with a motion under Section 657 or 663, it shall not be inferred on appeal . . . that the trial court decided in favor of the prevailing party as to those facts or on that issue."

There is no indication in the record that CPB attempted to "secure a statement of decision under Code of Civil Procedure section 632 *and*, pursuant to Code of Civil Procedure section 634, bring any ambiguities and omissions in the statement of decision to the trial court's attention." (*Fladeboe v. American Isuzu Motors Inc.* (2007) 150 Cal.App.4th 42, 58.) Thus, the only explanation available of the rationale for the judgment is the tentative decision. (See *In re Marriage of Ditto* (1988) 206 Cal.App.3d 643, 646-647 [improper to rely on tentative memorandum of intended decision rather than Code of Civil Procedure section 632 statement of decision to show trial court error].) CPB's efforts in its appellate briefs to parse the tentative decision for perceived inconsistencies or inaccuracies are not well taken. "The doctrine of implied findings

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second guess the original parties and re-draft the Irvine Company lease to which the parties agreed in 1977. The Court is disinclined to assume that task. As a consequence; the Court finds that Defendant has not met its burden of establishing a basis for an increase in the annual rent for the subject property; this is consistent with the unambiguous terms as set forth in the 'Ground Lease.'"

requires the appellate court to infer the trial court made all factual findings necessary to support the judgment. [Citation.] The doctrine is a natural and logical corollary to three fundamental principles of appellate review: (1) a judgment is presumed correct; (2) all intendments and presumptions are indulged in favor of correctness; and (3) the appellant bears the burden of providing an adequate record affirmatively proving error." (*Fladeboe v. American Isuzu Motors Inc.*, *supra*, 150 Cal.App.4th at p. 58.)

Without any citation to authority, CPB claims in its reply brief it was not required to seek further clarification of the tentative decision because the court indicated the tentative would "'serve as the Court's statement of decision unless within 10 days either party specifies controverted issues or makes proposals not covered in this tentative decision.'" However, we will not assume error by the court. At most, there are ambiguities in the tentative decision that could have been resolved had CPB requested further clarification within 10 days after the tentative decision. Our review of the judgment is limited to: (1) interpreting the relevant lease provisions; and (2) reviewing the court's factual finding (implied or otherwise) that no upward rent adjustment was warranted.

Interpretation of the Lease

The parties differ in their interpretation of the following lease language: "the basic rental shall be adjusted to that sum which the Lessor could derive from said property if it were made available on the open market for new leasing purposes for the use set out in Paragraph 4 below (exclusive of the value of Lessee's improvements thereon); provided, however, in no event shall the basic rental as so adjusted be less than the basic rental payable for the preceding period." CPB insists the lease provision does not prescribe a particular valuation methodology for determining the rental "sum," and further claims the court erred by applying such a limiting interpretation. Michelson asserts the lease provision requires the court to rely on the methodology espoused by its experts because the lease provision easily could have been drafted to specify the approach taken by Adams.

"We review a trial court's construction of a lease de novo as long as there was no conflicting extrinsic evidence admitted to assist in determining the meaning of the language. [Citation.] If a lease provision is ambiguous, parol evidence may be admitted as to the parties' intentions if the language is reasonably susceptible to a suggested interpretation. [Citation.] If there is conflicting evidence necessitating a determination of credibility, we use the substantial evidence test." (*California National Bank v. Woodbridge* (2008) 164 Cal.App.4th 137, 142.) The parties' disparate contentions as to the lease's proper interpretation do not amount to "conflicting extrinsic evidence . . . as to the intent of the" drafters of the lease. (*Id*. at p. 143.) The only extrinsic evidence bearing on the interpretation of the lease's *meaning* (as opposed to its application to the facts in this case) is the content of a rent adjustment provision in a different lease drafted by The Irvine Company, which sets forth a formula requiring an adjustment to "seven percent (7%) of the fair market value of the leased land . . . ." This provision explicitly calls for the approach Adams took in valuing the ground lease at issue. The parties disagree as to the relevance of this alternate rent adjustment "formula" provision; however, there is no conflicting extrinsic evidence as to the lease's meaning requiring credibility or other factual findings by the court. We will review de novo the meaning of the lease.

Notwithstanding the fact that The Irvine Company could have limited the rent adjustment methodology to an "Adams-style" fair market value analysis, we agree with CPB that the lease does not require or exclude the application of any of the particular valuation methodologies relied on by the parties. As we explain below, depending on the factual circumstances, different valuation methodologies may be more helpful than others in attempting to determine "that sum which the Lessor could derive from said property if it were made available on the open market for new leasing purposes." The language of the lease does not select or bar the use of a particular methodology, but instead presents a complicated valuation problem, which can be attacked from multiple angles.

We disagree, though, with CPB's contention that the court erred in its interpretation of the lease. As already noted, we will not presume error from the arguably ambiguous contents of the court's tentative decision. There is nothing in the record to indicate the court excluded Adams's testimony or report from its consideration of the evidence. The judgment implies the court found the value of the leasehold on the open market in 2002 to be $88,165 per year (or less) based on a careful weighing of the merits of the expert testimony presented by both parties, and this is the factual finding we review on appeal.

Admissibility of Michelson's Valuation Methodologies

The three basic property appraisal methodologies are "(1) the market data method, or comparable sale method; (2) the income capitalization method; and (3) the cost replacement, or reproduction cost method." (*Pacific Mutual Life Ins. Co. v. County of Orange* (1985) 187 Cal.App.3d 1141, 1147.) "The market value of commercial properties that derive their worth from the income they are capable of producing is generally calculated by means of the income capitalization approach, an appraisal technique that recognizes that buyers invest in income-producing properties with the expectation of receiving a return on their investment. The appraisal method by comparable sales, generally used for estimating the market value of single-family residential property, is not often useful in valuing large commercial properties, where the critical issue is the income the property is capable of producing." (*San Franciscans Upholding the Downtown Plan v. City & County of San Francisco* (2002) 102 Cal.App.4th 656, 684-685.)

The focus of Adams's analysis is the market data (comparable sales) method. Netzer (and to some extent Harty) utilize a combination of the "cost" approach and the "income capitalization" approach to property valuation. They estimate the amount it would take to construct an office building, estimate the income that could be generated by the completed office building, and derive conclusions about the desirability of the ground lease transaction to a potential lessee from those assumptions. CPB describes the approach taken by Netzer and Harty (as well as the approach taken by Adams in his "check" analysis) as the "land residual approach." As Adams explained, the typical land residual analysis identifies the difference between the market value of the property as improved and the cost to construct the necessary improvements to the property. The difference (market value – cost of construction) is the "land residual" — the estimate of pure land value without improvements.

CPB asserts all testimony and expert reports based on "land residual analysis" are inadmissible as a matter of law. CPB cites Evidence Code sections 810 through 824 and selected cases for the proposition that the "land residual approach" is inadmissible to establish the "value of property." (Evid. Code, § 810, subd. (a) ["[T]his article provides special rules of evidence applicable to any action in which the value of property is to be ascertained"]; *Sacramento etc. R.R. Co. v. Heilbron* (1909) 156 Cal. 408 [condemnation action]; *Contra Costa Water Dist. v. Bar-C Properties* (1992) 5 Cal.App.4th 652, 657 [eminent domain action in which court noted the "developer's approach (also known as the 'economic analysis' or 'residual land value' approach) as a method for measuring the fair market value of undeveloped land has been repeatedly held inadmissible by California courts"]; *Main & Von Karman Associates v. County of Orange* (1994) 23 Cal.App.4th 337 [tax assessment action].) The justification for this rule is the speculative nature of assuming vacant real property can and will be used for a particular purpose, such as a potentially lucrative residential subdivision, and further assuming the various costs of developing the proposed project. (*Contra Costa Water Dist. v. Bar-C Properties*, *supra*, 5 Cal.App.4th at pp. 657-658.)

CPB misconstrues the valuation question presented by the lease. The court was not required to determine the fair market value of the Property, as it would in a condemnation action or a tax assessment case (or in a case with a lease provision specifically measuring rent adjustment as a fixed percentage of fair market value of the property as of a certain date). Instead, the court was required to determine "that sum which the Lessor could derive from said property if it were made available on the open market for new leasing purposes," with a prescribed use (office buildings) provided in the lease. The lease actually requires the parties to assume the construction of a new office building on vacant land, and to determine the rent likely to accrue to CPB in 2002 assuming it had to lease the Property for 55 years to a tenant to build such an office building. There is no need in this case to protect against inflation of property values through speculative assumptions concerning the future development of the property — the lease requires an office building like that already constructed to be built on the hypothetical vacant Property in 2002.

CPB also mischaracterizes the approach taken by Michelson's experts, in particular Netzer. All of the experts applied analyses based in part on the income capitalization approach. Adams, performing a "check" on his sales comparison market value appraisal, completed a standard land residual analysis, solving for the market value of the unimproved Property. Netzer took a different approach in his analysis, opting to tailor the income capitalization methodology to the unique valuation problem presented by the rent adjustment provision. Netzer did not actually conduct a "land residual" analysis, but instead an "income residual" analysis, attempting to measure whether any income would remain to pay ground rent after paying for operation expenses and for a return to the potential lessee sufficient to convince the potential lessee to actually enter into the ground lease. Under the same rationale as Netzer, Harty performed his own calculations based on the analysis he performs as a developer, and further completed calculations based on the Adams land residual value approach.

Netzer's logic is compelling: the particular deal contemplated by the lease must appeal to a developer or other investor seeking a competitive return on investment. The Adams approach provides no direct insight into whether the deal contemplated by the lease would actually be accepted by a lessee in the 2002 marketplace. Put colloquially, CPB's approach attempts to measure the size of the piece of pie CPB "should" receive by extrapolating the average returns on investment of other similarly situated commercial landowners. Michelson's approach attempts to measure the size of the pie that can be baked given the specific recipe provided by the lease and market conditions, i.e., what is the maximum amount of annual rent an investor could promise to pay while still maintaining sufficient projected NOI to justify signing the lease.

In sum, the court did not abuse its discretion by admitting the valuation approaches developed by Michelson's experts. The rent adjustment provision's plain terms call for a calculation not readily completed using any established appraisal methodology. The approaches taken by each of the experts yield relevant information to the question of fact posed by the rent adjustment provision.

Review for Substantial Evidence

We review the court's factual finding (the ground lease rent should not be increased) for substantial evidence. "When a trial court's factual determination is attacked on the ground that there is no substantial evidence to sustain it, the power of an appellate court *begins* and *ends* with the determination as to whether, *on the entire record*, there is substantial evidence, contradicted or uncontradicted, which will support the determination, and when two or more inferences can reasonably be deduced from the facts, a reviewing court is without power to substitute its deductions for those of the trial court." (*Bowers v. Bernards* (1984) 150 Cal.App.3d 870, 873-874.)

Here, the parties agree substantial evidence must come in the form of expert opinion evidence. "The value of opinion evidence rests not in the conclusion reached but in the factors considered and the reasoning employed. [Citations.] Where an expert bases his conclusion upon assumptions which are not supported by the record, upon matters which are not reasonably relied upon by other experts, or upon factors which are speculative, remote or conjectural, then his conclusion has no evidentiary value. [Citations.] In those circumstances the expert's opinion cannot rise to the dignity of substantial evidence. [Citation.] When a trial court has accepted an expert's ultimate conclusion without critical consideration of his reasoning and it appears the conclusion was based upon improper or unwarranted matters, then the judgment must be reversed for lack of substantial evidence." (*Pacific Gas & Electric Co. v. Zuckerman* (1987) 189 Cal.App.3d 1113, 1135-1136.)

We agree with Michelson that Netzer's approach measures the economic feasibility of the ground lease transaction proposed in the rent adjustment provision. We further agree that the court was entitled to rely on a measurement of economic feasibility as a prerequisite to the assumption that a ground lease transaction would actually be consummated on the "open market." Thus, our review for substantial evidence will depend on whether there is support in the record for the data assumptions provided and conclusions drawn by Michelson's experts.

As explained above in the statement of facts, the cap rate used by the experts in calculating the feasibility of a ground lease at the Property is issue determinative. The other cost and income assumptions made by the parties are similar. It is helpful to illustrate the effect of the cap rate on an investor's assessment of the hypothetical transaction. The lease calls for an upward adjustment of rent if the rent that could be derived exceeds $88,165. Using Adams's cost ($13,497,000) and NOI (ignoring ground rent, $1,525,838) assumptions, the margin for paying rent gradually evaporates upon increases in the assumed cap rate:

Cap Rate	**NOI to Support Construction**	**NOI Available for Rent**
8.25%	$1,113,502	$412,336
9.00%	$1,214,730	$311,108
9.7%	$1,309,209	$216,629
10.00%	$1,349,700	$176,138
11.00%	$1,484,670	$41,168
15.00%	$2,024,550	-$498,712

If the court split the difference on cap rate estimates at 11 percent, and accepted Adams's assumptions on construction costs and NOI, the rent should not have increased as only $41,168 annually would be available to pay the rent. Harty's numbers work out similarly to those of Adams: according to Harty's best case scenario (with a 9.7 percent cap rate "too low for ground lease deals"), there would potentially be $215,057 available for ground lease payments. Using Netzer's cost ($11,260,800) and NOI (ignoring ground rent, $1,465,102) assumptions, the numbers do not differ tremendously:

Cap Rate	**NOI to Support Construction**	**NOI Available for Rent**
8.25%	$929,016	$536,086
9.00%	$1,013,472	$451,630
9.7%	$1,092,298	$372,804
10.00%	$1,126,080	$339,022
11.00%	$1,238,688	$226,414
12.00%	$1,351,296	$113,806
13.00%	$1,463,904	$1,198
15.00%	$1,689,120	-$224,018

Does the record contain substantial evidence supporting a finding of a minimum cap rate of at least 11 percent to 13 percent for an investor or developer to sign the ground lease (depending on whose cost and income assumptions are accepted)? There are reasons to question the applicability of Adams's 8.25 percent cap rate, not least of which is the fact Adams did not attempt to introduce positive evidence of the cap rate acceptable to a ground lessee. Why would a ground lessee accept the same cap rate as a fee simple buyer of commercial property? The fee simple buyer not only derives an annual return on investment, but also enjoys potential long term appreciation of the underlying land value and the remaining value of the improvements after 55 years. Plus, a fee simple owner faces fewer complications in obtaining financing for its projects, as it can pledge its fee simple ownership of the property as security and not just the leasehold. In sticking to his two-step fee simple owner methodology, Adams did not deign to introduce positive evidence of the minimum cap rate a ground lessee would accept in 2002.

Conversely, there are reasons to question Netzer's and Harty's cap rate evidence. Neither Netzer nor Harty attempted to actually determine an acceptable cap rate to a ground lessee, preferring to explain that the very notion of a ground lease to develop an office building in 2002 was inherently unworkable. Obviously, under any of the experts' cost and income assumptions, an assumed 13 percent (or higher) cap rate makes it impossible to develop an office building at the Property pursuant to a ground lease (even with no ground rent paid), despite historical evidence to the contrary that parties have utilized ground leases to develop office buildings in Irvine. Intuitively, this is problematic. Adams claims Netzer confused cap rates with a developer's one-time return for completing the construction of a building. There is some support for this inference in Netzer's statement that a 25 to 35 percent cap rate was required for a ground lease project — this seems shockingly high on its face. Put another way, a construction company might not be satisfied with a one-time 8 percent profit margin, but why would an office building investor care whether he owned the land? The investor would not need to buy the land at the outset of the ground lease, so the investor would not lose anything by not enjoying the appreciation of land value. Moreover, it is possible the economic life of the office building approximates 55 years. From this perspective, the investor should not demand a large cap rate premium in evaluating a ground lease investment versus a fee simple investment in a commercial office building site.

Unfortunately, none of the experts attempted to provide an actual market cap rate for office ground lessees (Adams was upfront about using a fee simple ownership cap rate, and Netzer and Harty both used illustrative numbers while insisting the actual cap rate would be even higher). However, we must conclude the court's finding of no rent adjustment is supported by substantial evidence. Netzer's methodology is based on generally accepted appraisal principles and modified to fit the unusual rent adjustment provision at issue. His conclusions are supported by the lack of comparable ground lease transactions in the 2002 marketplace and Harty's opinion that developers could not and would not develop the Property under a ground lease. Netzer, Harty, and Adams each make similar estimates and assumptions concerning the costs of development and the income generated from the Property with a new office building. The determinative finding of fact in the application of Netzer's methodology is the cap rate applicable to the hypothetical transaction at issue. We will not substitute our opinion for that of the trial court on this factual issue. (See *Hurwitz v. City of Orange* (2004) 122 Cal.App.4th 835, 855-856 [affirming admissibility and probative value of expert's cap rate estimate based on expert's 25 years of experience].)

None of this is to say Adams's utilization of comparable transactions was improper, or that the court would not have been entitled to find an upward rent adjustment. Had the court found the hypothetical transaction to be economically feasible (e.g., by finding a market cap rate of 9 percent for a ground lease transaction in 2002), the sales comparison approach would have added helpful data to determining a fair rent that could be derived in the open market. Netzer's methodology does not directly determine market rent; it determines whether sufficient income would be generated to make the deal rational for both the ground lessor and ground lessee. Indeed, had the comparable transactions utilized by Adams been more probative (e.g., had there been comparable ground lease transactions entered in 2002 to construct and operate office buildings on vacant land), perhaps the court would have rejected its reliance on Michelson's experts in favor of such evidence. As constituted, Adams's opinions and reports were admissible evidence, but the court was entitled to find those opinions were not probative in light of the dissimilarity of the transactions at issue in his comparables, and in light of the result of Netzer's and Harty's economic feasibility analyses. Even accepting Adams's appraisal of the land value of the Property and his appraisal of acceptable rates of return for commercial property owners, the court was still entitled to conclude such numbers had no bearing on what CPB could obtain in rent in the open market for a 55 year ground lease of unimproved property, with all restrictions and conditions placed on the lessee as set forth in the ground lease. There is substantial evidence supporting the finding that no rent adjustment was appropriate in 2002.

All that remains is the apparent paradox: how is it possible no upward rent adjustment is appropriate in light of the meteoric rise in the value of the underlying real estate? One partial answer may be construction costs rose and office building profit margins narrowed alongside the increase in real property values. Part of the answer is unlucky timing (for CPB); the lease drafters decided the lease would only be adjusted twice over 55 years, and market conditions in those two adjustment years would necessarily have a disproportionate impact on the determination of rental adjustments. Another piece to the puzzle is the apparent obsolescence of the ground lease in the Orange County office building market: without true market comparable transactions, it is more difficult to determine the rent CPB could derive from the Property for the purpose set forth in the lease. In the end, all that can be said with certainty is the court did not find evidentiary justification for a higher rent, and we will not overturn that result.

DISPOSITION

For the foregoing reasons, we affirm the judgment. Michelson shall recover its costs on appeal.

IKOLA, J.

WE CONCUR:

O'LEARY, ACTING P. J.

MOORE, J.